



## A BASIC SURVIVAL GUIDE TO ECONOMIC SUBSTANCE

### INTRODUCTION AND BACKGROUND

6 December 2018 saw the Government of Jersey pass the **Draft Taxation (Companies – Economic Substance) (Jersey) Law 201-** (the **Substance Law**). This not only changed the landscape for the 182 regulated trust company service providers but all Jersey resident tax companies (**Resident Companies**) as a whole. The Substance Law was sanctioned by Order of Her Majesty on 13 March 2019 and registered by the Royal Court of Jersey on 22 March 2019. By virtue of article 20 of the Substance Law, it came into law on 1 January 2019.

For a full copy of the Substance Law, please see: –

[https://www.jerseylaw.je/laws/adopted/Pages/Taxation\(Companies-EconomicSubstance\)Law.aspx](https://www.jerseylaw.je/laws/adopted/Pages/Taxation(Companies-EconomicSubstance)Law.aspx).

You will observe that the preamble of the Substance Law states that it is: –

*“**A LAW** to make provision for imposing an economic substance test on Jersey resident companies and for determining whether the test is met by assessing the extent of certain relevant activities carried out by such companies and taking appropriate enforcement action.”*

This guide sets out a high-level summary of the Substance Law with a view to enabling the reader to understand the bare essentials. It is not a substitute for specific legal advice.

The primary purposes of the Substance Law are to ensure that it meets the requirements of the EU Code of Conduct Group (Business Taxation) (**COCG**) in respect of economic substance and broadly to ensure that Jersey is ready for the implementation of the Organisation for Economic Co-operation and Development’s (**OECD**) base erosion and profit sharing (**BEPS**).

The main driving force behind COCG is to ensure that jurisdictions “*should not facilitate structures or arrangements aimed at attracting profits which do not reflect real economic activity in the jurisdiction*”. In particular, COCG’s starting point is the absence of a clear statutory requirement for economic substance “*increases the risk that profits registered in a jurisdiction are not commensurate with economic activities and substantial economic presence*”.

Most law firms and accountancy firms have produced preliminary briefing notes on the topic but it is still very much uncharted waters and shall remain so for the next few years.

## JERSEY'S RESPONSE – A GOOD NEIGHBOUR

As a good neighbour and a cooperative jurisdiction, Jersey has implemented the Substance Law in response to COCG's concerns. Jersey has actively engaged with numerous jurisdictions and organisations such as COCG, the OECD's Global Forum on Transparency and Exchange of Information for Tax Purposes, the Inclusive Framework on BEPS, the OECD's Forum on Harmful Tax Practices, individual EU member states, and the Crown Dependencies.

After consultation in August 2018, the Substance Law was published on 23 October 2018. Industry's view was that good corporate governance and high professional standards mean that most Jersey companies fall within scope of the substance requirements and will be able to demonstrate that they already meet the substance requirements. However, some may argue that this is an overstatement and each Resident Company should consider its position carefully.

## PIVOTAL ASPECTS OF THE SUBSTANCE LAW

These are: –

- ◆ scope and component elements of the economic substance test;
- ◆ circumstances in which the Jersey Comptroller of Taxes (the **Comptroller**) will exchange information obtained in relation to economic substance with other jurisdictions; and
- ◆ sanctions that will be applied where a company is determined to have failed the economic substance test.

## GUIDANCE NOTES

Official guidance notes have been and will continue to be published by the Comptroller, which are expressly referenced in the Substance Law, and an initial helicopter overview was first published on 7 November 2018. These can be found at: –

<https://www.gov.je/TaxesMoney/IncomeTax/Companies/Guidelines/Pages/EconomicSubstanceForCompanies.aspx>.

## HEALTH WARNING

The current Comptroller is Richard Summersgill CBE, who was previously at the UK HMRC. Since his appointment, he has made it his job to “get tougher on tax evasion”, which he made clear he would do in an interview in the Jersey Evening Post in November 2015. Accordingly, it will be extremely ill-advised to skimp on ensuring compliance with the Substance Law and its guidance notes.

## SCOPE

The Substance Law applies to “resident companies”, being a company that is tax resident in Jersey; that generates gross income during the relevant financial period and where such gross income relates to a “relevant activity”.

Residence is determined by the Income Tax (Jersey) Law 1961, as amended and includes non-Jersey companies managed and resident in Jersey.

Such companies must meet the “economic substance test”.

The Substance Law categorises “relevant activities” as: –

- ◆ **banking** business;
- ◆ **finance and leasing** business;
- ◆ **fund management** business;
- ◆ **headquarters** business;
- ◆ **holding company** business;
- ◆ **insurance** business;
- ◆ **intellectual property** holding business;
- ◆ **shipping** business; and
- ◆ **distribution and service centre** business.

Companies should be careful not to assume too quickly that they do not derive income from or carry on business in any of the “relevant activities”, particularly they should note the very wide definition of “intellectual property holding business”.

## BANKING

Save for a limited exception, this applies to a Resident Company that is registered to carry on deposit taking business under Article 9 of the Business Banking (Jersey) Law 1991.

## FINANCING AND LEASING

Finance and leasing business means the business of providing credit facilities of any kind for consideration. Consideration may include consideration by way of interest. Therefore, interest free lending may be out of scope, but it would seem that intra-group lending will comprise finance and leasing business. Where a loan is assigned to another person, that other person is deemed to be providing the credit facility.

This covers a Resident Company that carries on financing and leasing business if it makes loans, provides credit, or in any other way lends to any person. It includes hire purchase, leasing, conditional sale or credit sales.

## FUND MANAGEMENT

In a funds context, “*fund management business*” is defined in detail and includes managers that are licenced under the Financial Services (Jersey) Law 1998, as amended (the **FS Law**) for certain categories of fund services business as a manager, investment manager, trustee (unless there is a separate manager), and general partner (unless there is a separate manager).

The Substance Law also grabs a general partner/trustee of an unregulated fund; and a general partner/manager/trustee of a private fund (including a Jersey Private Fund, Private Placement Fund and Very Private Fund).

Accordingly, general partners/managers who are exempt from regulation under the FS Law must have regard to the Substance Law and where necessary ensure that the economic substance test is met.

## HEADQUARTERING

If a Resident Company provides any of the following services to a connected person of a Resident Company, it will be caught under this sphere: –

- a) provision of senior management;
- b) assumption or control of material risk for activities carried out by, or assets owned by, any of those connected persons; and
- c) the provision of substantive advice in connection with the assumption or control of any such risk.

## HOLDING COMPANY

A “holding company” is defined in the Substance Law as a corporate that has, as its “primary function”, the acquisition and holding of “shares or other equitable interests in other companies” and does not carry on any commercial activity.

Key points to note are that (i) a limited partnership or other form of vehicle is not within scope; (ii) if a company does not hold shares in companies, but rather holds real estate or other assets, then it will not be within scope; (iii) to be in scope its “primary function” must be to hold shares in companies, therefore, if it also carries on other activities (such as holding real estate or other assets directly), then a determination will be required as to whether its primary function is the holding of the shares; (iv) as above there must be gross income; and (v) the definition only captures companies that hold a majority interest in subsidiary companies/SPVs, and does not capture for example the holding of minority interests in listed companies (unless held via wholly/majority owned SPVs).

## INTELLECTUAL PROPERTY HOLDING

A higher standard is set for “high risk IP holding companies” (in short companies that hold intellectual property (IP) on behalf of a group without having independently generated that IP). Whilst generally the Comptroller may make a determination that any Jersey company does not meet the substance test, the Substance Law places a positive obligation on high risk IP holding companies to produce sufficient evidence to show that it does meet the substance test.

## SHIPPING

This includes managing crew (including hiring, paying and overseeing crew members), overhauling and maintaining ships, overseeing tracking deliveries and determining what goods to order and what to deliver them and organising and overseeing voyages.

## DISTRIBUTION AND SERVICE CENTRE

A company will be viewed as carrying on such activity if it comprises one or both of the following: –

- a) purchasing from a foreign connected person component parts, materials for goods or goods ready for sale, and reselling such component parts, materials or goods; and
- b) providing services to foreign connected persons in connection with the business.

## ECONOMIC SUBSTANCE TEST

Where a Resident Company undertakes any “*relevant activity*”, it must satisfy the economic substance test in relation to the “*relevant activity*” carried on by it. Companies will be assessed on their economic substance from the financial period starting on 1 January 2019.

A Resident Company meets the economic substance test in relation to a relevant activity if: –

- a) the company is “**directed and managed**” in Jersey in relation to that activity;
- b) having regard to the level of relevant activity: –
  1. there are an “*adequate*” number of employees physically resident in Jersey, whether or not employed by the Resident Company or by another entity and whether on temporary or long-term contracts;
  2. there is an “*adequate*” expenditure incurred in Jersey; and
  3. there are “*adequate*” physical assets in Jersey;
- c) the company conducts “**Jersey core-income generating activity**” (**CIGA**); and
- d) in the case of Jersey core-income generating activity carried out for the relevant company by another entity, it is able to monitor and control the carrying out of that activity by the other entity.

In essence, there are three limbs to the test. However, a Resident Company is not required to meet it if it has no income.

## DIRECTED AND MANAGED

This is not the same as the “*management and control*” test for tax residence.

The Substance Law specifies requirements of ways a company can be “*directed and managed*” in Jersey, including board meetings being held in Jersey at an adequate frequency, at such meetings a quorum of directors are physically present in Jersey, board minutes record strategic decisions of the company at meetings, directors have the necessary knowledge and expertise, and the minutes of all board meetings and records of the company are kept in Jersey.

The initial guidance notes suggest that the number of meetings required will depend on the activities, but it is generally expected that the majority of meetings should be in Jersey and there should be at least one meeting held in Jersey each year even for companies with minimal activities.

In a nutshell, there is no one size fits all answer to this test. Taking into account the vagueness here, one would recommend that a cautious approach is adopted.

## **CIGA**

What will constitute CIGA varies slightly depending on the nature of the business carried on. In a funds context, for example, in respect of fund management business it includes (i) taking decisions on the holding and selling of investments; (ii) calculating risk and reserves; (iii) taking hedging decisions; and (iv) preparing reports and returns to investors and the Jersey Financial Services Commission/other regulators; whilst for a headquarters business the focus is on (a) taking relevant management decisions; (b) incurring expenditure on behalf of group entities; or (c) co-ordinating group activities. For holding companies, all activities related to the business comprise CIGA.

The guidance notes confirm that it is not necessary for the company to perform all of the CIGA listed in order to demonstrate substance. An example the guidance notes give is a company that holds a patent does not have to carry on the CIGA of marketing, branding and distribution as well as the research and development.

## **OUTSOURCING**

It is notable that the Substance Law specifically refers to third party service providers, in relation to employees "...whether or not employed by the resident company or by another entity"; and also CIGA "carried out for the relevant company by another entity" (provided that the relevant company can monitor and control the carrying out of that activity by the other entity).

On balance and provided that the Resident Companies currently apply best practice, our opinion in a financial services context is that most holding companies and general partners/managers to investment funds (for example) will be able to rely on the substance already being provided by their Jersey resident directors, corporate services providers and fund administrators to demonstrate compliance with the economic substance test.

This opinion is confirmed by the initial guidance notes, which confirm that: –

- ◆ outsourcing outside the Island is permitted, and expert professional advice and services can be sought from other jurisdictions, but the income subject to tax in Jersey must be commensurate to the CIGA undertaken in Jersey;
- ◆ if some or all of the CIGA is outsourced, the company must be able to demonstrate that it has adequate supervision of the outsourced activities and, to meet the substance requirements, that those activities are undertaken in the Island;
- ◆ where a CIGA is outsourced the resources of the service provider in the Island will be taken into consideration when determining whether the people and premises test is met. However, there must be no double counting if the services are provided to more than one company; and
- ◆ the company remains responsible for ensuring accurate information is reported on its tax return and this will include precise details of the resources employed by its service providers, for example based on the use of timesheets.

## **ADEQUATE EMPLOYEES, EXPENDITURE, PHYSICAL ASSETS**

The Substance Law provides that the Comptroller may issue guidance including as to the meaning of “adequate” and specifies that “regard must be had to any guidance” that is so issued.

The guidance notes provide that “adequate” is not a defined term, and therefore has its ordinary meaning, and notes that *the dictionary definition of “adequate” is: “Enough or satisfactory for a particular purpose”*.

The guidance further provides that what is adequate for each Resident Company will be dependent on the particular facts of the Resident Company and its business activity. A Resident Company will have to ensure it maintains and retains appropriate records to demonstrate the adequacy of the resources utilised and expenditure incurred.

## **FILINGS WITH COMPTROLLER**

The form of tax return is currently being amended so that the necessary information will be supplied to the Comptroller as part of the usual tax return process for Resident Companies.

A Resident Company must provide any information reasonably required by the Comptroller in order to assist the Comptroller in making a determination as to whether the substance test is met. This will generally be in the form of information provided on the company’s tax return.





The Comptroller may also serve notice on any person requiring them to provide, within a period of time specified in the notice, any documents and information the Comptroller may reasonably require.

The Comptroller (or any person authorised by the Comptroller) may, at any reasonable time, enter business premises and take copies of any business document located on the premises for the purposes of investigating compliance with the Substance Law.

## **REPORTING AND EXCHANGE OF INFORMATION WITH COMPETENT AUTHORITIES**

Generally, where the Comptroller determines that a Resident Company has not met the economic substance test for a financial period, the Comptroller must provide all information provided to it by the company pursuant to the Substance Law to: –

- a) the competent authority in the country or territory in the European Union in which the following entities relating to the company reside: –
  - 1. its holding body;
  - 2. its ultimate holding body; and
  - 3. its ultimate beneficial owner; and
  
- b) if the Company is incorporated outside Jersey, the country in which the company is incorporated.

In respect of high-risk IP companies, the Comptroller must provide any information it has received pursuant to the Substance Law to the parties listed above, regardless of whether or not it is determined to have met the economic substance test.

The Comptroller's obligation to disclose information to any competent authority under the law overrides any other duty of confidentiality that may exist in respect of the information provided, be that imposed by contract, statute or otherwise.

## SANCTIONS – IMPRISONMENT AND FINES

The sanctions are progressive in nature including financial penalties and disclosure of information to foreign revenue authorities.

If the Comptroller determines that the economic substance test has not been met for a financial period, the Comptroller will issue a notice to the company notifying it: –

- a) that the Comptroller has determined that the Company does not meet the economic substance test;
- b) of the reasons for that determination;
- c) of the amount of any fine imposed and the date on which is due (up to a maximum of £10,000 increasing to £100,000 if the test is not met for consecutive financial periods);
- d) of what action needs to be taken to ensure that the Company does meet the economic substance test; and
- e) of the company's right of appeal.

A fine of up to £3,000 is payable if a person fails to provide information to the Comptroller when required. Similarly, a fine of up to £3,000 is payable where inaccurate information is provided where (i) the person knew the information provided was inaccurate at the time it was provided; or (ii) the person subsequently discovers the information is inaccurate and fails to take reasonable steps to inform the Comptroller.

A person who (i) obstructs; or (ii) fails to provide reasonable assistance to the Comptroller or any person authorised by the Comptroller when they enter a business premises to take copies of documents, is guilty of an offence and is liable to a fine and/or imprisonment for up to six months.

A person who intentionally alters, suppresses or destroys any business document that has been requested by the Comptroller pursuant to the Substance Law is also guilty of an offence and liable for a fine and/or imprisonment for up to two years.

## ACTION PLAN

It is highly recommended that companies take the following immediate steps to alleviate the risk of falling foul of the Substance Law: –

- ◆ ensure board meetings are regularly held in Jersey on a quarterly basis;
- ◆ insist that the board minutes capture the full discussions of the board meetings as opposed to rubber stamping of decisions;
- ◆ make sure that the directors have the requisite skills, experience and qualifications so that they can be reasonably expected to manage and control the company;
- ◆ regularly assess the levels of CIGA conducted inside and outside of Jersey;
- ◆ retain all company records and major documents in Jersey;
- ◆ ensure that the company has sufficient staff, premises and expenditure in Jersey;
- ◆ insist that any outsourcing and administration agreements meet the substance test; and
- ◆ ensure that all key decisions are taken in Jersey.

---

### LEXSTONE LAWYERS

Hawk House | 22 Esplanade | St Helier | Jersey JE2 3QA | Channel Islands

D: +44 1534 480 700 | E: [enquiries@lexstone.je](mailto:enquiries@lexstone.je)



This publication is for general guidance only and does not constitute definitive advice. Formal legal advice in all relevant areas should be sought before relying upon any of the information contained in this release.

© Lexstone Limited 2019